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IN THE

SUPREME COURT of the UNITED STATES

OCTOBER TERM, 1931.

No. 413

THE AETNA CASUALTY AND SURETY CO.,
Petitioner,

v.

PHOENIX NATIONAL BANK AND TRUST CO.,
Respondent.

Brief for Respondent.

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Lexington, Kentucky.

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No. 413

THE AETNA CASUALTY AND SURETY CO.,
Petitioner,
v.
PHOENIX NATIONAL BANK AND TRUST CO.,
Respondent.

Brief for Respondent.

The petitioner seeks a review, by writ of certiorari to the United States Circuit Court of Appeals for the Sixth Circuit, of the judgment of said Court entered November 12, 1930, pursuant to a written opinion filed on said date and found in 44 Federal, (2nd) 511. The petition for rehearing was denied on June 30, 1931 (R. p. 111).

FACTS

The facts are substantially as stated in petitioner's brief, with such exceptions and additions as may be hereinafter referred to and set forth.

ARGUMENT

This case involves the construction of a bond executed by the petitioner, The Aetna Casualty and Surety Company, to the respondent, Phoenix National Bank and Trust Company; the

cause was argued and submitted in the Circuit Court of Appeals of the Sixth Circuit on February 3, 1930; after mature deliberation the uanimous opinion of the Court was delivered November 12, 1930, and a petition for rehearing filed December 12, 1930, was denied on June 30, 1931. This opinion, carefully considered and unanimously concurred in, gives a construction to the contract of insurance involved which is supported by established principles of law, and is sound and logical.

I.

THE RELATION BETWEEN BANK AND DEPOSITOR IS THAT OF DEBTOR AND CREDITOR, AND THE BANK PAID OUT ITS OWN MONEY UPON THE CHECKS, RAISED AND/OR WITH FORGED ENDORSEMENTS.

The rule that the relationship between a bank and a general depositor is that of debtor and creditor is fundamental and if the bank pays checks which have been raised or upon which there is a forged endorsement of the payee's name, the bank pays out its own money and not that of the depositor.

In the case of Henderson Trust Company v. Ragan, 21 Ky. Law Reporter, 601, 52 S. W. 848, the Court said:

> "The rule is well settled that, if a bank pays a check on a forged endorsement, it must sustain the loss. Tied. Com. Paper, par. 449. Where money is paid upon a pretended, not a real endorsement of the name of the payee, in law, the check remains unpaid and can not diminish the funds of the borrower in the bank or the money in the pocket of the person entitled to the payment. Bank v. Whitman, 94 U. S. 347."

In Rice v. Citizens National Bank, 21 Ky. L. R. 346, 51 S. W. 454, the Court said:

> "A deposit in bank of an ordinary deposit creates the relation of debtor and creditor . . . . It is immaterial whether this deposit of $700.00 be treated as a general deposit or as a deposit for a special purpose other than bailment. The money was paid out precisely as the special instructions with the deposit provided, except that the signatures of the payees of the checks were forged. The principle seems to be well settled that a payment by a bank of a check to any person save the payee himself, except it be payable to bearer, is a payment at its peril. If the signature of endorsement is genuine, it is a payment out of the depositor's fund; if it is forged it is a payment out of the bank's funds and the depositor can not be charged with it. Shipman v. Bank (N. Y. App.), 27 N. E. 371; Hatton v. Holmes (Cal.), 31 Pac 1131; Bank v. Whitman, 94 U. S. 347; Bank v. Morgan, 117 U. S. 112; Bank v. Burke (Ga.) 7 S. E. 739, and many other cases . . . . We conclude that the bank is liable to appellants for this deposit. The payment on a forged check was a payment by appellee at its peril. It was not a payment of apellant's funds, however great the care used by the appellee. It is not a question of care or negligence. The payment was not to the payee of checks but a payment on what purported to be his order. The order (endorsement on the check) was a forgery. For this payment appellants are in no way liable. There was no relation of principal and agent between the appellants and appellee. It was pure debtor and creditor."

When the bank paid the various checks with forged endorsements, it paid out its own money and sustained a loss as and when the respective checks were paid.

The opinion of the Circuit Court of Appeals states the rule as follows:

> "The relation between banker and depositor is that of debtor and creditor; the money with which the check is paid is the money of the bank; its contract with the deposi-

tor only entitles it to charge back to, and collect from, the depositor the amount of a valid check so paid. When it pays a forged check it has no right to make this counter charge, and its loss continues to be its loss."

II.

THE LOSS COVERED BY THE POLICY WAS INCURRED BY THE BANK AS AND WHEN THE VARIOUS CHECKS WERE PAID.

An analysis of the language of the bond or policy of indemnity insurance involved in this case shows that the loss of the bank as and when the checks were paid was the loss covered by the bond.

In the case of Fitchburg Savings Bank v. Massachusetts Bonding and Insurance Company, Mass. , 174 N. E. 324, (1931) a question very similar to the one involved in this case arose. This suit was upon a "Banker's Blanket Bond." By methods we need not relate, the Treasurer of the insured bank, through his fraud and dishonesty, abstracted from the bank about $50,000.00, and the bank in the transactions received several notes with endorsers thereon. The surety company contended that the loss covered by the bond was the net amount irrecoverable after all rights against others than the surety had been exhausted. The court said:

> "In this bond the word 'loss' means the deprivation or dispossession of money or property of the bank due to the dishonest, criminal or fradulent acts of its officers, regardless of the security the bank has for the loss, and that the 'loss' occurred and was suffered by the plaintiff, without regard to its possible remedies, when its funds in fact were diverted on October 8, and 10, 1925, through the fraud and dishonesty of its treasurer. Forbes v. Manufacturers' Ins. Co.;

1 Gray, 371; Queenan v. Palmer, 117 Ill. 62, 619, 629, 7 N. E. 470, 613; Mitchell Grain & Supply Co. v. Maryland Casualty Co., 108 Kan. 379, 384, 195 P. 978, 16 A. L. R. 1488; First National Bank of Crandon v. United States Fidelity & Guaranty Co., 150 Wis. 601, 607, 137 N. W. 742; American Surety Co. of New York v. Lawrenceville Cement Co. (C. C.) 96 F. 25, 30; Champion Ice Manuf. & Cold Storage Co. v. American Bonding & Trust Co., 115 Ky. 863, 874, 75 S. W. 197, 103 Am. St. Rep. 356."

In construing the language of the bond so as to thus define the loss covered thereby, the Court said:

"The evidence would not warrant a finding that the plaintiff had exhausted every remedy it has against Nichols and the indorsers on the notes. It is, therefore, the contention of the defendant that the plaintiff has sustained no loss, or if it has, that it can recover nominal damages only.

"A definition of the loss for which the defendant as surety is liable as the net amount irrecoverable after all rights against others than the surety have been exhausted clashes with several sections of the bond. Section 6 provides that '* * * * the Underwriters upon payment of any loss hereunder shall become subrogated to all the rights and remedies of the Insured in respect of such loss.' Section 9 provides: 'At the earliest practicable moment, and at all events not later than ten days, after the Insured shall discover any loss hereunder, the Insured shall give the Underwriter notice thereof by registered letter or telegram. * * * Legal proceedings for recovery of loss hereunder shall not be brought * * * after the expiration of twelve months from the discovery of such loss. If any limitation embodied in this paragraph is prohibited by any law controlling the construction hereof, such limitation shall be deemed to be amended so as to be equal to the minimum period of limitation permitted by such law.' Under the provisions of the contract it is obvious that the definition of 'loss' suggested by the defendant as the measure of its liability under its contract with the plaintiff might result in denying the insured a remedy altogether through its inability to exhause its rights against third persons within the limitations of time allowed in the

bond for bringing actions against the defendant. It is plain such a result unless absolutely required should not be held to express the intention of the parties. American Surety Co. v. Pauly, 170 U. S. 133, 144, 18 S. Ct. 552, 42 L. Ed. 977."

The same may be said as to the bond in the present case. It provides (1) that the insured shall give written notice of any loss as soon as possible after learning of such loss; (2) that the insured shall, within ninety days after learning of such loss, file an itemized proof of claim duly sworn to; (3) that no action shall be brought under the bond in regard to any loss unless begun within twelve months after the insured shall learn of such loss.

If the contention of the petitioner should prevail that the loss for which it is answerable is the net amount irrecoverable after all rights against others, including the depositor, have been exhausted, the result would probably be a denial to the insured of a remedy upon the bond through its inability to have judically determined the controversy with the depositor, and to exhaust its remedies against endorsers of the checks—in other words, to attempt to recoup its loss—within the limitations of time allowed in the bond for bringing actions thereon. No doubt if the bank had required the depositor to sue it and had brought suit against the endorsers of the checks, the year within which it could, under the terms of the bond, file suit thereon would have expired before such litigation had terminated.

The only provision in the bond involved in the above cited case, of those referred to by the court as supporting its conclusion that the loss covered by the bond occurred when the bank's funds were diverted and paid out, without regard to a possible recoup-

ment, which is not found in substance in the bond in the present case, is that which provides that the insurer shall, upon payment of any loss, be subrogated to the rights and remedies of the insured with respect to such loss. The absence of such a provision is not material, because as a matter of law the insurer had such right. On this point the Circuit Court of Appeals said:

> "If the Surety Company could get the benefit of any rights the bank had to recover its loss, or part of it, from others, it would be by paying the loss and acquiring these rights through subrogation. (Travellers Co. v. Great Lakes Co.,—C. C. A. 6,—184 Fed. 426, 430; U. S. Fidelity Co. v. Union Bank,— C. C. A. 6,—228 Fed. 448, 452). The Surety Co. was doubtless entitled itself to give the necessary notices. Its request to the bank to do so was not in connection with any offer to pay up its liability, so that it might be entitled to have them given for it; the request was in connection with a denial of all liability."

An adjudication between the respondent bank and its depositor that the loss arose by and upon the payment made by it as the checks raised and with forged endorsements were presented to it, continued to be its loss, is not a condition precedent to recovery against the Surety Company upon its bond. Ocean Accident & Guaranty Corporation v. Old National Bank, 4 Fed., (2nd) 753.

III.

THE BANK WAS NOT REQUIRED TO RECOUP OR ATTEMPT TO RECOUP ITS LOSS SUSTAINED THROUGH PAYMENT OF THE CHECKS BEFORE PROCEEDING AGAINST THE INSURER.

Without again quoting therefrom, the case of Fitchburg Savings Bank v. Massachusetts Bonding and Insurance Company,

supra establishes the proposition that the insured need not recoup its loss before suing upon the bond and obtaining judgment against the Surety Company.

In Champion Ice Manufacturing Co., v. American Bonding Co., 115 Ky. 863, 75 S. W. 200, the court said:

> "It would be restricting the law of both insurance and suretyship to an absurd degree to say that appellee cannot be held liable until after appellant, having exhausted every other remedy or prosecuted to insolvency any other who might be liable, is still not reimbursed. In other words, appellee's liability does not depend upon whether appellant might collect the stolen $500, from some one else, having a right of acton against the defaulter, Weitkamp, but appellant has also the right of action against the guarantor of his honesty."

In First National Bank v. U. S. Fidelity and Guaranty Company, 137 N. W. 744, the Court said:

> "If the plaintiff were required to exhaust its remedies against Price and Eidsmoe before it could have recourse against the defendants, it might well be that it could not comply with the conditions of the bond at all, because it might not be able to enforce its remedies against these parties within the time which the bond attempts to limit for commencement of suit thereon. It appears to be quite clear that the language of the bond gives the plaintiff an absolute right to recover its loss from the surety as soon as it occurs, and not the qualified one to recover only so much of the loss as cannot be recovered from those responsible for it."

25 Corpus Juris, 1111, reads as follows:

> "A fidelity bond, indemnifying aganst dishonesty, is essentially an insurance contract, guaranteeing the payment, and not a mere guarantee of collection, upon which the insured can recover only after exhausting his remedies against those primarily liable."

To the same effect is the case of Saridersville Oil Mill Co. v. Globe & Rutgers Fire Insurance Co., 124 S. E. 728.

IV.

THE BANK WAS NOT REQUIRED UNDER THE TERMS OF THE POLICY TO LITIGATE WITH ITS DEPOSITOR IN AN ATTEMPT TO RECOUP ITS LOSS, BECAUSE (1) IT DESIRED TO KEEP ITS DEPOSITORS AND NOT TO ALIENATE THEM; (2) IT PROBABLY WOULD HAVE BEEN UNSUCCESSFUL IN THE LITIGATION BECAUSE (a) A DEPOSITOR IS UNDER NO DUTY TO EXAMINE CANCELLED CHECKS FOR FORGED ENDORSEMENTS; (b) NOTICE TO A DEPOSITOR'S AGENT HAVING A HOSTILE PERSONAL INTEREST IS NOT NOTICE TO THE DEPOSITOR; (c) THE DEPOSITOR, THOUGH IT WERE NEGLEGENT IN EXAMINING THE CANCELLED CHECKS, MIGHT HAVE ESTABLISHED THAT THE BANK WAS NEGLIGENT IN PAYING THE CHECKS, AND (3) HAD THE DEPOSITOR PREVAILED IN THE LITIGATION IT WOULD PROBABLY HAVE BEEN TOO LATE UNDER THE TERMS OF THE BOND TO SUE THEREON, AND (4) THE SURETY SHOULD AND COULD HAVE PAID THE LOSS TO THE BANK, BECOME SUBROGATED TO ITS RIGHTS, AND ATTEMPTED TO SALVAGE THE LOSS IF IT DESIRED.

We think we have established that the loss contemplated by the bond arose when the checks were paid; that the bank was under no obligation to proceed against the endorsers on the checks

or otherwise attempt to recoup its loss, and yet the petitioner contends that by recrediting the amount of the checks to the depositor's account the obligation of the surety company was discharged.

Under such a bond as this the bank is not required and ought not to be required to engage in litigation with its depositor under the facts appearing in this record.

This is aptly stated in the opinion of the Circuit Court of Appeals in the following language:

> "We think, therefore, that the policy should be read as indemnity against the original loss, and not as holding the liability in the air until it can finally be determined whether the bank had a right to make the charge back. It is not reasonable to suppose that bank intended to buy that kind of indemnity. Banks wish to keep their depositors, not to alienate them. They would desire protection against the payments induced by forgery, not against the uncollectability of claims resulting from such payment."

The opinion further reads as follows:

> "We hold now only that the bank is not obliged to contest with the depositor any plausible claim by the latter that it has not become liable for the loss; and that, if there is any reasonable ground of litigation, the bank is not obliged to carry the burden of the resulting controversy."

Litigation between the bank and the depositor would have been hazardous as to the outcome, and the bank would probably have been unsuccessful because (a) a depositor is under no duty to examine cancelled checks for forged endorsements. National City Bank of Chicago, Ill. v. Third National Bank of Louisville, Kentucky, 177 Fed. 136 (at page 140). Jordan-Marsh Co. v. National Shawmut Bank, 201 Mass. 397, 87 N. E. 740, 22 L. R. A. (N. S.) 250 (at page 255); Welsh v. German American Bank, 73 N. Y. 424, 29 Am. Rep. 175; Shipman v.

Bank of State, 126 N. Y. 318, 27 N. E. 373, 12 L. R. A. 791; Annotations, 67 A. L. R. 1125, and 15 A. L. R. 166;

And (b) notice to depositor's agent having a hostile personal interest is not notice to the depositor. American Surety Co. v. Pauly, 170 U. S. 133;

And (c) even though the depositor were negligent in examining the cancelled checks, if the bank were negligent in paying the checks the depositor would prevail. Union Tool Co. v. Farmers & M. National Bank, 192 Cal. 40, 218 Pac. 424, 28 A. L. R. 1417; Coleman Drilling Co. v. First National Bank (Texas), 252 S. W. 215; Glassel Development Co. v. Citizens National Bank, 191 Cal. 375, 216 Pac. 1012, 28 A. L. R. 1427; U. S. v. National Bank of Commerce, 205 Fed. 433, 7 C. J. 688.

Had the depositor prevailed in the litigation with the bank it would in all probability have been too late under the terms of the bond for the bank to recover thereunder, as we have hereinbefore pointed out, and the surety company should and could have paid the loss to the bank, stepped into the bank's shoes, become subrogated to all of its rights, and have attempted to recoup the loss if it saw fit.

As stated in the opinion of the Circuit Court of Appeals, "it would be most unfortunate for such an issue to be tried in a case to which the depositor was not a party, and where it would not be bound. Whether the surety company could have brought in the depositor as a party, or could recover against it, we need not consider."

In conclusion we submit that the Circuit Court of Appeals has correctly construed the bond under consideration, which was

written by the surety company, and should be most strongly construed against it, and that there is no occasion for the judgment of the Circuit Court of Appeals being reviewed by writ of certiorari, and we therefore respectfully ask that the petition for the writ of certiorari be denied.

Respectfully submitted,

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